

5-30-2014

# Watch Intra-Family Financial Transactions

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## Recommended Citation

Harl, Neil E. (2014) "Watch Intra-Family Financial Transactions," *Agricultural Law Digest*: Vol. 25 : No. 11 , Article 1.  
Available at: <http://lib.dr.iastate.edu/aglawdigest/vol25/iss11/1>

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**Agricultural Law Press**

Publisher/Editor

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# Agricultural Law Digest

Volume 25, No. 11

May 30, 2014

ISSN 1051-2780

## Watch Intra-Family Financial Transactions

-by Neil E. Harl\*

Rapidly rising farmland values<sup>1</sup> and rising farm incomes have had a major impact on family relationships. One notable effect has been on perceptions of fairness based on estate and business plans originating in an earlier era, as recently discussed in these pages.<sup>2</sup> Another, of nearly equal importance, involves financial assistance within families that may balloon with higher input costs and higher machinery costs as the younger generation strives to adjust to a new level of both income and expenses. Financial assistance by parents (or grandparents) to the farming generation may have seemed reasonable a few years ago but may have climbed sharply in recent years to the point where the assistance becomes an issue with the Internal Revenue Service.

### An example

Assume a parent had been persuaded by a farming son several years ago to help in the acquisition of a quarter section of farmland as the land became available nearby. The two agreed to set up a limited liability company (LLC), with the son as the managing member, to buy the land, each contributing \$50,000 with the rest financed by a mortgage on the land. The land was rented to the son's farming operation. For the first few years, rents were kept low because of low commodity prices. Economic pressures on the son's operation because of some bad weather seasons, low commodity prices and interest on the land left little to be distributed to the two LLC members. Even in years when there was a balance above property taxes and interest on the mortgage, it was retained in the LLC and used, first for improvements on the land and then to trade machinery – which was owned, not by the LLC, but by the son. That practice continued over the years with little left to be distributed to the LLC members. The parent finally raised the question of why the distributions were so modest and learned, after considerable questioning, that it had gone mostly to upgrade the son's equipment.

### What difference does it make?

The problem is that Congress in 1984 tightened up the rules on financial assistance provided by family members and other related parties.<sup>3</sup> The statute has been amended several times since 1984.<sup>4</sup>

The general rule under the 1984 statute is that, for a below-market loan, which is a gift loan or demand loan, the foregone interest is treated as transferred from the lender to the borrower and retransferred by the borrower to the lender as interest.<sup>5</sup> The transfers are generally considered made on the last day of the calendar year.<sup>6</sup>

*Gift loans.* The term "gift loans" means a below-market loan where the foregoing of

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interest is considered a gift.<sup>7</sup> Generally a loan is a gift loan if property is transferred for less than full and adequate consideration with donative intent. Uncharged interest on interest-free or below market interest loans represents a gift to which the federal gift tax provisions apply. For a gift loan directly between individuals, the amount treated as retransferred by the borrower to the lender as of the close of the taxable year is not to exceed the borrower's net investment income for the year.<sup>8</sup> However, that does not apply if the aggregate outstanding amount between the borrower and the lender exceeds \$100,000.<sup>9</sup> Interest is imputed on loans of which the balance of the loans between the parties exceeds \$100,000. No interest is imputed for loans of \$10,000 or less if the loan is not directly attributable to the purchase or carrying on of income-producing assets and the loan does not have federal tax avoidance as one of its principal purposes.<sup>10</sup> Foregone interest is the amount of interest that would have been earned on the loan if the amount were loaned at the "applicable federal rate" reduced by the amount of interest paid on the loan.<sup>11</sup> However, the Seventh Circuit Court of Appeals has held that the proper rate is the rate at which the donee could have obtained funds.<sup>12</sup>

A loan to a trust which is treated as a revocable trust is governed by the grantor trust rules.<sup>13</sup>

It is important to note that, in the case of a below-market gift loan, a possibility exists of both gift tax and income tax liability.

**Demand loans.** The term "demand loan" means any loan which is payable in full at any time on the demand of the lender.<sup>14</sup> The term includes any loan with an indefinite maturity.<sup>15</sup> In the case of a demand loan, the applicable federal rate is the federal short-term rate (one to three year loans).<sup>16</sup>

**Term loans.** A "term loan" is any loan that is not a demand loan.<sup>17</sup>

**Compensation-related loans.** Any below-market loan is considered as a below-market loan if it is between an employer and an employee, a corporation to a shareholder, an independent contractor and a person for whom the independent contractor provides services or any other compensation-related situation.<sup>18</sup> Such loans if interest-free or below market loans result in imposition of income tax liability annually for both term and demand loans.<sup>19</sup> For "cross loans" between a corporation and its shareholders, the foregone interest on a loan by the corporation to its shareholders is treated as a distribution to the shareholder and is generally taxed as a dividend; the foregone interest on a loan by a shareholder to the corporation is treated as a capital contribution.<sup>20</sup>

#### Implications for planning

With the lower interest rates in recent years, particularly for short term loans (one to three years), the consequences of related-party loans subject to the provisions of *I.R.C.* § 7872 and the regulations thereunder have been less severe than in normal times. Nonetheless, attention to the rules for loans with below-market interest rates is advisable. Remember, gifts in excess of the federal gift tax exclusion<sup>21</sup> (if available) come out of the \$5,340,000 applicable exclusion amount (for 2014) inasmuch as gift tax, estate tax and generation-skipping transfer tax are now unified with one applicable exclusion amount.<sup>22</sup>

#### ENDNOTES

<sup>1</sup> See, e.g., Duffy, 2013 Iowa Land Value Survey, Iowa State

University Extension, December, 2013 (\$8,716 average per acre statewide; 5.1 percent increase in value over 2012).

<sup>2</sup> Harl, "Fairness in Estate and Business Planning," 23 *Agric. L. Dig.* 145 (2012).

<sup>3</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 172, 98 Stat. 494 (1984), enacting *I.R.C.* § 7872.

<sup>4</sup> E.g., Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

<sup>5</sup> *I.R.C.* § 7872(a)(1).

<sup>6</sup> *I.R.C.* § 7872(a)(2).

<sup>7</sup> *I.R.C.* § 7872(f)(3).

<sup>8</sup> *I.R.C.* § 7872(d)(1)(A).

<sup>9</sup> *I.R.C.* § 7872(d)(1)(D).

<sup>10</sup> *I.R.C.* § 7872(d)(1)(B).

<sup>11</sup> *I.R.C.* § 7872(c).

<sup>12</sup> *Cohen v. Comm'r*, 910 F.2d 422 (7th Cir. 1990).

<sup>13</sup> *I.R.C.* §§ 671-679. See the Committee Report on Pub. L. No. 98-369, 98 Stat. 494 (1984). See also Rev. Rul. 85-13, 1985-1 C.B. 184; CCA 201343021, June 17, 2013 (Chief Counsel's Office has ruled that grantor trusts are disregarded as entities separate from their owners for all federal income tax purposes).

<sup>14</sup> *I.R.C.* § 7872(f)(5).

<sup>15</sup> *I.R.C.* § 7872(f)(5).

<sup>16</sup> *I.R.C.* § 7872(f)(2)(B). See *I.R.C.* § 1274(d).

<sup>17</sup> *I.R.C.* § 7872(f)(6).

<sup>18</sup> *I.R.C.* § 7872(c)(1)(B).

<sup>19</sup> *Mason v. Comm'r*, T.C. Memo. 1997-352.

<sup>20</sup> *Cutts v. Comm'r*, T.C. Summary Opinion 2004-8.

<sup>21</sup> *I.R.C.* § 2503(b).

<sup>22</sup> See *I.R.C.* § 2505(a), as amended by American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101, 126 Stat. 2313 (2012).

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